SUPREME COURT, U. S.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1968

No. 1281

MISSISSIPPI VALLEY PORTLAND CEMENT COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

CHARLES CLARK
1741 Deposit Guaranty Bank Bldg.
Jackson, Mississippi
VARDAMAN S. DUNN
1741 Deposit Guaranty Bank Bldg.
Jackson, Mississippi
Attorneys for Petitioner

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106. HArrison 1-3030

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Now comes the Petitioner, Mississippi Valley Portland Cement Company, and respectfully petitions the Court for the granting of a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit, to review the decision in a tax refund case hereinafter described.

STIPULATION AND OPINIONS BELOW

An action was filed by Petitioner in the United States District Court for the Southern District of Mississippi, for recovery of corporate income taxes assessed but paid under protest (28 *U.S.C.*, § 1346). It was submitted on a stipulation of facts (Appendix A, infra). An opinion was filed in favor of Respondent (Appendix B, infra). An appeal was perfected by Petitioner to the Court of Appeals for the Fifth Circuit, and that Court affirmed the decision of the District Court (Appendix C, infra).

JURISDICTION

The Fifth Circuit entered its judgment on March 14, 1969 (Appendix D, infra). Petitioner invokes the jurisdiction of this Court under 28 *U.S.C.*, § 1254(1). The jurisdiction of the United States District Court was invoked under 28 *U.S.C.*, § 1346, and the appeal was taken from that Court as authorized by 28 *U.S.C.*, § 1291.

QUESTIONS PRESENTED

I. Where there is a legally binding corporate charter and contract obligation to produce a commodity (cement) for corporate member-stockholders *at cost*, does this constitute "business done with *or* for patrons" within the exclusionary provisions relating to the income of non-tax exempt cooperatives, when all of the production is allocated prorata in advance of such production?

II. Is the first stated question affected by the fact that the member-stockholders are not all consumers of the corporate product and that there is an absence of horizontal similitude or fraternal commercial relationship among stockholders in relation to the product produced?

III. May lawfully binding charter and contract provisions establishing legal relationships as between a corporation and its stockholder members be wholly disregarded and set at naught for tax purposes, despite the binding effect thereof as among the parties involved under sanction of state laws?

STATUTES INVOLVED

26 *U.S.C.* 1388 provides:

"§1388. *Definitions; special rules*

"(a) *Patronage dividend.*—For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies—

"(1) on the basis of quantity or value of business done with or for such patron,

"(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

"(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."

SUMMARY OF REASONS FOR GRANTING WRIT

The Court of Appeals has decided an important question of federal law which has not been, but should be settled by this Court, and has decided a federal question in a way in conflict with applicable decisions of this Court. The case is of national importance in relation to the administration of the tax laws of the United States. It involves the question of the effect to be given to the laws of the respective states in establishing legal relationships and property rights for tax purposes, and presents an opportunity for this Court to provide guidelines for the appropriate interplay as between the Nation's tax laws and the State's laws of property and to define "income" in relation to the circumstances of this and similar cases involving non-tax exempt cooperatives.

STATEMENT OF THE CASE

Petitioner Mississippi Valley Portland Cement Company, hereinafter sometimes called "Company" or "Taxpayer", organized under the laws of the State of Mississippi in 1956. As shown by its charter, it was organized and recognized as a cooperative. Its declared charter purpose was to manufacture cement for the account of its stockholder-patrons at cost.*

The underlying basis for the Petitioner's claim is that the net margins were received under its charter and the law of the State of its creation only for the account of its stockholder-patrons, and that Petitioner never owned or had any power to retain the margins in its own right. Otherwise expressed, the Petitioner acted only as a conduit

*It is what is sometimes referred to in tax parlance as a "taxable cooperative" or "non-exempt cooperative", the terms being used to distinguish its corporate composition from that of a so-called "exempt cooperative", as in the case of a "farmers' cooperative" under Section 521, *Internal Revenue Code* of 1954.

through which the funds flowed, without ever attaining any beneficial ownership of or control over the margins realized for the account of its principals and therefore never received "income" subject to corporation income taxes.

The lower Courts disagreed. The Court of Appeals took the view that Petitioner's cooperative form was a sham and that its principals—the stockholders—were mere paper patrons and that Petitioner was not privileged to avoid "income" by production at cost, despite its legal charter and contract obligation so to do, and despite its recognition as a non-profit corporation by the State of its creation. The underlying reasoning was that Petitioner's stockholders had no fraternal commercial relationship as cement users and were not all identifiable as users of the product allocated to them at cost.

The conclusions thus reached serve to deny to taxpayers the right to choose their form of doing business and to avoid receiving income by producing commodities at cost under a binding contract so to do. The decision strikes at the very foundation of the right of citizens to contract freely in relation to their property interests and at the right of the State to enact laws determining the relative property rights of its citizens.

The form thus chosen did, of course, have its tax consequences as well as its business consequences. Unlike an ordinary corporation-stockholder relationship: (1) the Corporation was obliged to pay out *all* net margins in the year received and hence could not expand or build up equity by retaining earnings in the business, and (2) the stockholders were obliged to take the distributions credited to their patronage accounts and pay taxes thereon as ordinary income with little or no chance to build up equity appreciation for capital gains tax treatment. Tax-wise and business-wise there was some of the good and some of the

bad in the form adopted. Without debating whether this increased or diminished the tax revenue to the United States, Petitioner's point is that the ownership of income was fixed by contract and by law and, good or bad, the parties and the State had the right to adopt the form and take the consequences.

I.

Basic Facts

The basic facts were stipulated, and the pertinent facts stated below are taken therefrom (See Appendix A, infra).

Petitioner was chartered by the State of Mississippi and organized on February 17, 1956.

The Company has outstanding approximately 1,800,000 shares of stock, and approximately 90% of its stockholders live in the State of Mississippi. The corporation was organized for the purpose of constructing and operating a cement manufacturing facility near Redwood, Mississippi, and it "was organized as a cooperative." (PR. 113-114).

During that period of its corporate life during which stock was being sold, the Company filed Registration Statements with the Securities and Exchange Commission of the United States and also with the Securities Divisions of the State of Mississippi and several surrounding states. The prospectus, as included in the Registration Statements and issued as a basis for the sale of stock, clearly stated that the Company was organized as a cooperative, and that every stockholder had a "patronage right" to purchase cement in proportion to the number of shares of stock held and to assign the patronage rights. It was further pointed out in these documents that the cement thus allocated, pursuant to patronage rights, would be sold at the market price

to the stockholders or their assigns, but that to the extent that the sales price exceeded the cost of production and sale, patronage refunds would be paid to stockholders annually in proportion to the amount of cement delivered to them or their assignees (PR. 112-113).

It is significant that the character of the Company as a cooperative, in relation to patronage distributions, was given wide publicity and that the Company was permitted to dispose of its capital stock on the basis of the representations contained in the prospectus and Registration Statement. This authorization came from the United States through the Securities and Exchange Commission, as well as from the State of Mississippi and surrounding states.*

Pertinent excerpts from the Charter of Incorporation are quoted in the stipulation (Stip. Par. 8, PR. 113-116). It is stipulated that the Charter, as amended, indicates that the Company as organized under the laws of the State of Mississippi "was organized as a cooperative". The Charter provides that the record owner of every five shares of stock has a preferred patronage right to purchase one barrel of cement; that the patronage right is paramount to the rights of all other persons, firms or corporations, and that all Company contracts for the sale and delivery of cement are subject thereto. The Charter further provides that the Board of Directors may allocate cement pursuant to the patronage rights and adopt reasonable rules for the handling and distribution of the cement so allocated, and that the Board might increase or decrease the patronage rights only upon a pro rata basis. The Charter further provides that the patronage rights can be assigned in whole or in part upon terms consistent with the Charter and By-Laws, and finally:

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*Therefore, there can be no doubt of the intent of the Company to operate as a cooperative, or of the expectation of its stockholders that such would be accomplished, or of the acquiescence of the public authority therein.

> ". . . Any excess of the sales price of cement sold pursuant to patronage rights over its cost as determined in accordance with this subparagraph* shall be refunded to each stockholder of record as a patronage rebate in proportion to his, or his assignees' (who is a stockholder) patronage during the fiscal year, . . ."

As set forth in the stipulation, the Board of Directors, "in accordance with its Charter provisions and authority vested in the Board of Directors under the corporation's "By-Laws," did unanimously adopt on January 26, 1959, a resolution relating to the allocation of cement, and did adopt similar resolutions in January of each succeeding year. These resolutions as to the allocation of cement are substantially identical, except for dates, and by way of summary, provide as follows: That for the fiscal year in question, "there is hereby allocated to stockholders of record the right to purchase at cost the total of 100% of the production of the Company of marketable cement for said period, which shall be no less than one barrel for each five shares of stock owned." The resolutions spell out the method of arriving at the cost of production, and then provide for the method of handling and distribution, as follows (Stip., PR. 116-118):

> "3. Each stockholder of record shall have the right to take his allotted share of cement in kind and in such event he shall pay to the company the going market price, subject to the stockholder's right to a patronage rebate as herein provided for. In case the stockholder shall fail to take his allotted share in kind, then such share may be dealt with as hereinafter set forth.
>
> "4. The Company shall honor assignments by stockholders of their patronage rights and will consider any assignee as an agent of the assignor for the purchase of cement and for the receipt of all patronage rebates.

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*The subparagraph referred to is subparagraph (f) of Article 7 of the Charter of Incorporation, quoted in full in the stipulation (PR. 115).

"5. The profits, as above defined, shall belong to the stockholder-patrons as received by the Company and shall be held for their account in trust and shall be refunded to each stockholder of record as a patronage rebate in proportion to patronage rights exercised by such stockholder or his assignee, during the fiscal year, except that all or any part thereof may be applied against any indebtedness of the stockholder to the Company or to any subsidiary. This obligation shall be enforceable as a contract between the company and its stockholder-patrons and their assigns."

The resolutions concluded by spelling out the method of making rebates, the dealings with Valley Cement Sales, Inc. as assignee of many of the stockholders, and the forfeiture of patronage rights under certain conditions, and then concluded that the provisions of the resolution would continue to apply from year to year until altered or changed by action of the Board.

It is stipulated that these resolutions "were strictly carried out." (Stip. Par. 9, PR. 116). *It is also stipulated that for the tax years in question the Company did "conduct its business in accordance with the rights and powers embodied in its Charter, By-Laws, corporate resolutions and existing contracts had with its stockholder-patrons."* (Stip. Par. 15, PR. 120). Also, the Company, in accordance with its Charter provisions and contracts had with stockholder-patrons and within the statutory period provided for in the Internal Revenue Code and regulations issued thereunder and administrative rulings, paid the specified net margins to its stockholder-patrons and excluded said amounts so allocated or paid in arriving at the amount of its taxable income, and returns were also prepared and filed with the State Tax Commission for the State of Mississippi, likewise excluding said amounts from taxable income, in the belief that the entire margin attained was at all times the property of its stockholder-patrons or their assigns, and "In

those returns it claimed, and was allowed, as a deduction and/or exclusion those amounts allocated and/or paid as patronage rebates by it under the terms of its Charter and By-Laws to its stockholder patrons."

In summary, the stipulation settles these factual points for purposes of this case, viz: (1) The corporation was organized and chartered as a cooperative; (2) Its charter, by-laws and resolutions obligated the corporation in advance to produce cement for its stockholders at cost; (3) The production of cement for which the corporation is sought to be taxed was allocated in advance of production to stockholders on a pro rata basis; (4) Sales of the cement thus allocated and produced for its stockholders at cost were handled for the stockholders by a duly designated agent of the stockholders; (5) It operated strictly in accordance with its charter, by-laws and resolutions, and in practice carried out its assumed charter obligations to the letter; and (6) Its modus operandi was spelled out in a prospectus on which its stock was sold with the acquiescence of and under permit from the United States Securities and Exchange Commission and under like permits from comparable agencies of four different states.

II.

Amplification of Reasons for Allowance of Writ

Since Petitioner operated strictly in accordance with its charter of its creation, the question resolves itself into one of law. The question of law is whether Petitioner's corporate function and the correlative limitations upon its power to possess or own "income" is to be honored or disregarded in the area of Federal taxation.

Petitioner was certainly not a "sham" in any sense of failing to act in accordance with its charter and contract limitations and obligations, because the stipulation states

the Company did "conduct its business in accordance with the rights and powers embodied in its Charter, By-Laws, corporate resolutions and existing contracts had with its stockholder patrons." This simply was to produce cement for its stockholder-patrons at cost. It was not a "sham" in the sense that it had any secret scheme of operation, because its modus operandi was fully disclosed in its registration with the Securities and Exchange Commission. In short, it could only justly be called a "sham" if it is denied the consequences of its fully authorized and fully disclosed corporate purpose and prevented by judicial fiat from producing its commodity for its principals at cost.

The Petitioner was created for its stated purpose by the State. The power to create corporations is one of the attributes of sovereignty. 18 *Am.Jur.2d*, Corporations, §§ 25 and 30. In Mississippi, the right granted a corporation in its charter "is the same as if a statute had been passed to that effect by the Legislature." *Estes* v. *Bank of Walnut Grove* (1935), 172 Miss. 499, 159 So. 104. As pointed out in *Lindsay & Phelps Co.* v. *Mullen* (1899), 176 U.S. 126, 20 S.Ct. 325: ". . . A corporation which is organized under a general law is as much 'chartered by law' as one whose organization is provided for by a special act. . . ." (20 S.Ct. at 329).

The Charter fixed the economic consequences by placing the ownership of net margins in the stockholders and withholding it from the corporate producer so that the economic benefit vested not in the corporation but exclusively in the stockholders. Since this amounted to the passage of a statute by the State Legislature, the question comes as to whether a Federal judicial power should be exercised to strike down the enactment by rejecting its legal consequences. Petitioner submits that such an exercise of power is of such grave concern as to be deserving

of an in-depth investigation by this Court. And especially is this so where, as here, the Charter provisions are used as the basis of a public stock sale under a full disclosure registration with the Securities and Exchange Commission.

Petitioner does not claim an "exemption" or a "deduction" from income. By contrast, it claims only the right to exclude from the concept of income that which it never received and which under the law of its charter it could never receive under a proprietary claim, since all net margins belonged to someone else.

Thus, Petitioner is not driven to a reliance upon legislative grace or administrative practice but upon the determination of what constitutes gross income. This, in turn, depends upon whether the tax assessed here was laid in the first instance. Since the statute only lays the tax upon "income", the case must, of necessity, turn upon the determination of whether un-owned margins constitute income to the Petitioner as producer. Do these statutes taxing income apply to Petitioner? As held in *Gould* v. *Gould* (1917), 245 U.S. 151, 38 S.Ct. 53, 62 L.Ed. 211: "In case of doubt they are to be construed most strongly against the government, and in favor of the citizen." Also, *United States* v. *Merriam* (1923), 263 U.S. 179, 44 S.Ct. 69, 68 L.Ed. 240, 29 A.L.R. 1547.*

The statute dealing with non-exempt cooperative ventures (28 *U.S.C.* 1388, quoted supra) specifically excludes from income amounts paid to patrons on the basis of the value of business "done with or for such patron," on certain specified conditions. While excludability from

*In both cited cases, this Court construed the term "income." It excluded, in the first case, alimony to a divorced wife, and in the second, legacies given an executor "in lieu of compensation or commission."

income does not depend upon legislative grace, all such statutory conditions were met in the instant case. All production was allocated in advance to stockholders on a pro-rata basis, pursuant to a charter obligation which amounted to a contract, and all production involved was delivered to the assignees of the stockholders.

As put in *Dixie Electric Power Assn.* v. *Hosey* (Miss., 1968), 208 So.2d 751:

> "The corporate charter has been characterized as the 'Constitution' of an incorporated body. It is a contract between the state and the corporation and between the corporation and its stockholders. 18 Am. Jur.2d Corporations §§ 84, 85 (1965)."

Therefore, we submit that since no right to income ever accrued, none was realized and there was not present here the "economic benefit" to the corporate entity which is requisite to the consideration of gain as income. On this point, this Court's decisions were summarized in *United States* v. *Rochelle* (CA 5, 1967), 384 F.2d 748, as follows:

> "The Supreme Court, after many years of hesitation, has now firmly concluded that the economic benefit accruing to the taxpayer is the controlling factor in determining whether a gain is 'income'. Rutkin v. United States, 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833; Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 75 S.Ct. 473, 99 L.Ed. 483; James v. United States, 366 U.S. 213, 81 S.Ct. 1052, 6 L.Ed.2d 246. A loan does not in itself constitute income to the borrower, because whatever temporary economic benefit he derives from the use of the funds is offset by the corresponding obligation to repay them. See James v. United States, supra 266 U.S. at 219, 81 S.Ct. at 1055."
>
> (384 F.2d at 751)

Petitioner submits that the obligation of the corporate contract embodied in its charter with the State and the stockholders has been erroneously impaired and the resulting imposition of a tax against one on the assets of another is contrary to due process of law as guaranteed by the Constitution. For example, this Court in *Hoeper v. Tax Commission of Wisconsin* (1931), 248 U.S. 206, 52 S.Ct. 120, struck down a State statute which sought to tax to one the income of another, saying:

> "We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income. . . ."
>
> (52 S.Ct. at 122)

CONCLUSION

It is hard to conceive of 6000 people (stockholders in Petitioner) joining hands with the State, under the critically watchful eyes of the Securities and Exchange Commission, to perpetrate a sham, as has been held by the Court of Appeals.

Petitioner submits that the Fifth Circuit opinion sets a precedent for (1) the taxation of one person's property and income by reference to the property or income of another, (2) the impairment of contract obligations sanctioned by State governments, and (3) the unnecessary interference with the realities of State sovereignty in the area of the fixation of property rights.

For the reasons stated, Petitioner submits that the Writ should be granted.

Respectfully submitted,

CHARLES CLARK
1741 Deposit Guaranty Bank Bldg.
Jackson, Mississippi
VARDAMAN S. DUNN
1741 Deposit Guaranty Bank Bldg.
Jackson, Mississippi
Attorneys for Petitioner

APPENDIX A

Stipulation of Facts*

It is hereby stipulated by and between the parties hereto, by their respective counsel, that the following facts may be considered by the Court as though fully established in determining the issues in this cause:

1. The Plaintiff, Mississippi Valley Portland Cement Company, is a corporation organized and legally existing under the laws of the State of Mississippi. It is domiciled and has its principal place of business in Vicksburg, Warren County, Mississippi, and jurisdiction in this action against the United States of America, Defendant, is vested by Title 28, U.S.C. Section 1346, as amended.

2. This action is for the recovery of income taxes which Plaintiff, hereinafter sometimes called taxpayer, contends were wrongfully and erroneously assessed and collected for the taxable years ended January 31, 1962, January 31, 1963 and January 31, 1964; and which Defendant contends were lawfully and properly owed and collected from Plaintiff.

3. Mississippi Valley Portland Cement Company was organized under the laws of the State of Mississippi on February 17, 1956 (R-200).

4. The history of the corporation includes the following facts and statistics:

(a) On February 6, 1956, a corporation by the name of Vicksburg Properties, Inc., was chartered with an issuance of 100,000 shares at a price of $1.80 per share to approximately forty shareholders. The proceeds of the

*Exhibits have been omitted in view of the reproduction of pertinent excerpts therefrom in the body of the stipulation.

stock subscriptions were used, in part, to buy land, upon which a limestone quarry was to be established.

(b) On March 23, 1956, the assets of Vicksburg Properties, Inc. were transferred to the plaintiff, which had been incorporated on February 17, 1956, in exchange for 500,000 shares of plaintiff's capital stock. Vicksburg Properties, Inc. then cancelled its outstanding capital stock and distributed the 500,000 shares of plaintiff's stock to its forty shareholders proportionately.

(c) The principal owners of the original stock of plaintiff were as follows:

Name	Shares	Occupation
R. W. Hyde	69,798	Pres., Construction Co.
Cecil F. Travis	46,993	Attorney
James W. Sanders	46,993	Pres., Textile Co.
A. N. Morgan*	83,911-1/3	Accountant
Kent B. Diehl	50,005	Consulting Engineer
David W. Adams	42,855	Public Relations Counsel
Calvin Huffman	66,230	Businessman; Promoter
James Fowler	10,000	Pres., Automobile Agency
Total	416,785-1/3	

The balance of the 500,000 shares were owned by friends, relatives, employees and relatives of the above.

(d) During the period from its inception, plaintiff's directors have been as follows: As shown on a schedule attached hereto as Exhibit *1.*

(R-201)

*Held in various trusts for benefit of Mr. Morgan's minor children and wife.

(e) Pursuant to prospectuses, dated March 30, 1956 and April 5, 1957, an additional 1,400,000 shares of stock were sold to the general public in the states of Mississippi, Louisiana, Tennessee and Arkansas. At and subsequent to those dates, the plaintiff's stock has been listed in the Over The Counter market and may be purchased and has been held by the public at large.

5. Registration Statements authorizing the sale of its shares of stock were filed with the Securities and Exchange Commission in Washington, D. C. and the Securities Divisions of the States of Mississippi, Tennessee, Louisiana, and Arkansas.

Approximately 90% of its stockholders live in the State of Mississippi.

6. The corporation was organized for the purpose of constructing and operating a cement manufacturing facility near Redwood, Mississippi.

7. The Registration Statements filed with the Securities and Exchange Commission and the Securities Divisions of the States of Mississippi, Tennessee, Louisiana, and Arkansas stated that the corporation was being organized as a cooperative. An excerpt taken from the prospectus dated April 5, 1957 (page 4) follows:

> The Company is organized as a cooperative. Its charter gives every stockholder a "patronage right" to purchase cement in proportion to the number of shares of stock held, and to assign his patronage right if he does not wish to exercise it. Several of the Company's directors (Messrs. Hyde, Travis, Sanders and Morgan, who are respectively President, Vice President, Treasurer and Controller) plan to organize a separate corporation to act as a selling agency through which those stockholders who have no use for cement will be able, at a charge, to sell the cement to which they are en-

titled. That corporation will be wholly owned by the four directors mentioned, with perhaps a few other persons. Its charges for services will be recovered by the Company's stockholders only if they receive patronage refunds of at least an equal amount. But the selling agency's charges will be so fixed that they will merely meet the estimated cost of its selling services and return to its stockholders not more than 5% on their cash investment. (R-202)

The cement allocated pursuant to patronage rights will be sold in all cases at the market price, whether the cement is actually sold to stockholders for their own use or to persons to whom they have assigned their patronage rights. But, to the extent that the sales price of the cement exceeds the production and sales costs, and after provision is made by the board of directors for retirement of any indebtedness and for working capital, patronage refunds will be paid to stockholders annually in proportion to the amount of cement delivered to them or their assignees. Those stockholders who use cement themselves will thus acquire it substantially at cost, and those who assign their rights will receive any patronage refunds as a return on their investment. Of course, there is no assurance that the Company will operate at a profit and, therefore, there can be no assurance of patronage refunds.

8. A copy of the corporation's Charter and all amendments thereto is attached hereto as Exhibit A. Reference thereto will indicate that the corporation, as organized under the laws of the State of Mississippi, was organized as a cooperative. The following is a true excerpt from the corporation's Charter as amended.

"7. The purposes for which it is created:

"To manufacture, buy, sell, and deal in cement of all kinds, lime, limestone, plaster and natural and artificial stone; and to erect, or buy, lease or otherwise acquire manufactories, kilns and buildings; to build,

maintain and operate manufactories, kilns, silos, warehouses, and depots for manufacturing and storing, buying, selling and dealing in cement and other products and to transport, or cause to be transported the same, and to do any and all things incidental thereto and necessary and proper to be done in connection with the matters and things aforesaid or any of them.

"(a) The record owner of every five shares of stock has a preferred patronage right to purchase one barrel of the Company's cement during each fiscal year beginning with the first full fiscal year in which the Company is in production. The patronage rights of Stockholders are paramount to the rights of all other persons, firms or corporations which may deal with the Company. All Company contracts for the sale or delivery of cement shall be made subject thereto.

"(b) The Board of Directors may (i) allocate cement, pursuant to the patronage rights herein described, on a monthly, quarterly, semi-annual or annual basis, (ii) adopt reasonable rules for the handling and distribution of the cement so allocated, and (iii) provide in those rules that failure of stockholder to conform thereto terminates his patronage rights. Patronage rights not exercised during the period for which allocation is made under Clause (i) herein lapse unless the Board of Directors provides otherwise by rule under Clause (ii) herein or by resolution.

"(c) The Board of Directors may increase the patronage rights of all share *pro rata*. Any increase shall become effective (R-203) on the first day of the month following the Board's resolution or on the first day of any earlier or later month specified in the resolution, and shall remain effective for any period specified in the resolution or in any event until appropriate provision is made in a later resolution of the Board.

"(d) The Board of Directors may decrease the patronage rights of all shares *pro-rata* for the current or next monthly, quarterly, semi-annual or annual fis-

cal period if it appears to the Board that production will be insufficient during that period to meet the patronage rights specified in subparagraph (a).

"(e) The patronage rights may be assigned, in whole or in part, upon any terms consistent with the Charter and by-laws, and any rules adopted under subparagraph (b).

"(f) Within a reasonable time after the end of each fiscal year, the Board of Directors shall determine, in accordance with generally accepted accounting and business procedures, the cost of producing and selling cement per barrel during the fiscal year. The term 'profit' as used herein means any excess of the sales price of cement sold otherwise than pursuant to patronage rights over its cost as determined in accordance with this subparagraph. Any excess of the sales price of cement sold pursuant to patronage rights over its cost as determined in accordance with this subparagraph shall be refunded to each stockholder of record as a patronage rebate in proportion to his, or his assignees' (who is a stockholder) patronage during the fiscal year, except that the Board of Directors, by a resolution adopted in the prior fiscal year, may reduce patronage rebates in order to provide funds deemed by the Board of Directors to be adequate for debt retirement and working capital to the extent that such funds are not available from the Company's 'profit' as herein defined. No amendment of any such resolution increasing the funds provided for debt retirement and working capital may become effective earlier than the beginning of the fiscal year after the amendment is voted. The Directors may not set aside funds to provide for the retirement of any debt before the earliest date at which the debt may be paid or called.

"(g) The Board of Directors may pay dividends in cash or stock to the extent of any 'profit' (as that term is defined in subparagraph (f) after the Board provides funds deemed by it to be adequate for debt retirement and working capital.

"(h) The Board of Directors may apply all or any part of any patronage refunds or cash or stock dividends owing to a stockholder as well as all or any part of the shares owned of record by a stockholder at their book value or any reasonably ascertainable market value, whichever is lower against any indebtedness of the stockholder to the Company or to any subsidiary."

(R-204)

9. In accordance with its Charter provisions and authority vested in the Board of Directors under the corporation's By-Laws, the Board of Directors did unanimously adopt on January 26, 1959, a Resolution relating to the allocation of cement, a copy of which is hereto attached as Exhibit A-1.

Similar Resolutions have been adopted in January of each succeeding year, with such being applicable to the next succeeding fiscal period which commenced on February 1st. Attached hereto as Exhibit B, Exhibit C, and Exhibit D are those Resolutions adopted by the Board of Directors on January 16, 1961, January 17, 1962, and January 16, 1963, respectively.

These Resolutions as to the allocation of the entire production had by this corporation in three fiscal years here involved and next succeeding to the date of the Resolution, to the Corporation's stockholder-patrons and/or their assigns, were strictly carried out.

The pertinent portion of the Resolution adopted under date of January 16, 1961 and applicable to the fiscal year ended January 31, 1962 follows:

"RESOLVED AS FOLLOWS"

1. For the fiscal year of Mississippi Valley Portland Company beginning February 1, 1960, and ending January 31, 1961, there is hereby allocated to stockholders

of record the right to purchase at cost the total of 100% of the production by the Company of marketable cement for said period, which shall be no less than one barrel for each five shares of stock owned. Said allocation shall be calculated on a prorata basis as of the end of the fiscal year, as between and among stockholders of record on the last day of the year.

(R-205)

2. The cost of such cement shall be the per barrel cost of operating the business of the Company, including the cost of producing and selling cement per barrel during said fiscal year plus such depreciation and depletion as may be allowable for tax purposes by the United States Internal Revenue Service, and plus a figure equal to such accumulated losses and costs as have been incurred for general and administrative expenses, organizational costs and starting up costs prior to the beginning of the fiscal year. The proceeds of any sales of cement to customers who are not stockholders or assignees of stockholders and sales in excess of patronage rights held shall be first applied in defraying said cost. The cost shall be calculated within a period of 75 days after the end of said fiscal year in accordance with generally accepted accounting and business procedures and the term "profit" as hereinafter used shall mean any excess of the sales price of cement sold over cost as determined in accordance with this paragraph.

3. Each stockholder of record shall have the right to take his allotted share of cement in kind and in such event he shall pay to the company the going market price, subject to the stockholder's right to a patronage rebate as herein provided for. In case the stockholder shall fail to take his allotted share in kind, then such share may be dealt with as hereinafter set forth.

4. The Company shall honor assignments by stockholders of their patronage rights and will consider any assignee as an agent of the assignor for the purchase of cement and for the receipt of all patronage rebates.

5. The profits, as above defined, shall belong to the stockholder-patrons as received by the Company and shall be held for their account in trust and shall be refunded to each stockholder of record as a patronage rebate in proportion to patronage rights exercised by such stockholder or his assignee, during the fiscal year, except that all or any part thereof may be applied against any indebtedness of the stockholder to the Company or to any subsidiary. This obligation shall be enforceable as a contract between the company and its stockholder-patrons and their assigns.

6. All patronage rebates found to be due shall be distributed in cash or Reserve Certificates within ninety (90) days after the close of the said fiscal year. If the Company's finances, in the judgment of the Board of Directors, permit, said rebates shall be made in cash, but otherwise, in the discretion of the Board, said rebates shall be credited to the stockholder or his assignee and same shall be payable under such terms and conditions as may be authorized by the Board of Directors commensurate with maintaining the financial integrity of the Company and the obligation for payment shall be evidenced by Reserve Certificates issued by the Company and bearing interest at the rate of 5% per annum until paid.

(R-206)

7. Sales of cement will be made to or for the account of Valley Cement Sales, Inc., a Corporation organized as a sales agency for the benefit of stockholder-patrons who assign to it their patronage rights, at the market price to consumers less a quantity discount to be negotiated between the two Companies and the Company will rebate to Valley Cement Sales, Inc. in accordance with the total patronage rights of its assignors as covered in said assignments.

8. Any cement produced and not taken by stockholders or their assignee by the 30th day of the month following production may be sold on the open market by Mississippi Valley Portland Cement Company for

the account of its stockholder-patrons, as their interests may appear, or the Company may deliver such unclaimed cement to Valley Cement Sales, Inc. on the terms aforesaid.

9. The provisions of this resolution shall continue to apply from year to year until altered or changed by action of the Board of Directors.

On motion duly made and seconded, the foregoing Resolution was unanimously adopted."

Substantially identical provisions are embodied in the Resolution of January 17, 1962, and the Resolution of January 16, 1963.

10. In order to carry out the provisions of the corporate Charter and By-Laws relative to stockholder-patron's rights, there was organized, prior to the commencement of manufacture of cement, a corporation known as Valley Cement Sales, Inc. This corporation was organized as a cooperative under the laws of the State of Mississippi. This corporation has functioned as a sales agent for various stockholder-patrons taking their cement from Mississippi Valley Portland Cement Company. A copy of the assignment and contract had as between the stockholder-patron, Valley Cement Sales, Inc., and Mississippi Valley Portland Cement Company is attached hereto as Exhibit E.

11. Approximately 90% of the stock of Mississippi Valley Portland Cement Company was represented by executed assignments to Valley Cement Sales in 1960, when the company began production of cement. All stockholders received the same pro-rata distributions whether assignments were executed or not, at times pertinent to this suit. (R-207)

12. In the years ended January 31, 1962-1964, inclusive, the entire amount of production had by Mississippi Valley Portland Cement Company was, in accordance with

properly executed assignments on the part of its stockholder-patrons, or in accordance with the provisions of the Charter and resolutions of its Board of Directors as aforesaid, delivered by Mississippi Valley Portland Cement Company to Valley Cement Sales, Inc.

13. All of the distributions to stockholder-patrons, above were made on a pro-rata basis to plaintiff's stockholders of record at the close of its fiscal year.

14. Any stockholder who sold his stock at any time prior to the close of the fiscal year was not entitled to share in the allocation or distribution of any patronage or other distributions with respect to earnings for the fiscal year of sale.

15. Mississippi Valley Portland Cement Company did in the years ended January 31, 1962-1964, inclusive, conduct its business in accordance with the rights and powers embodied in its Charter, By-Laws, corporate resolutions and existing contracts had with its stockholder-patrons.

16. The corporation, in accordance with its Charter provisions and contracts had with stockholder-patrons and/or their assigns, did within the statutory period provided for in the Internal Revenue Code, Regulations issued thereunder; and Administrative Rulings promulgated by the Internal Revenue Service, allocate and/or pay the following net margins to its stockholder-patrons and excluded said amount so allocated or paid in arriving at the amount of its taxable income: (R-208)

Year Ended	Margin Allocated or Paid to Stockholder Patrons
1-31-62	$285,215.14
1-31-63	454,208.41
1-31-64	421,296.68

The foregoing represents the excess of funds turned over to Mississippi Valley Portland Cement Company for the account of its stockholder-patrons over its cost to produce that cement delivered to them and/or their assigns. A portion of the above margins applicable to the years 1962 and 1963 was paid in script, a specimen of which is attached and hereinafter referred to, Exhibit *E-1.*

(Statistically, for the year ended 1-31-61, the margin allotted or paid stockholder-patrons was the sum of $296,770.05.)

17. In the years ended January 31, 1962-1964, inclusive, Mississippi Valley Portland Cement Company did file tax returns with the State Tax Commission for the State of Mississippi. In those returns it claimed, and was allowed, as a deduction and/or exclusion those amounts allocated and/or paid as patronage rebates by it under the terms of its Charter and By-Laws to its stockholder-patrons.

18. Taxpayer filed timely income tax returns with the District Director of Internal Revenue in Jackson, Mississippi for each of the year ended January 31, 1962-1964, inclusive. These returns were prepared in the belief that the entire margin attained by the taxpayer from the production of cement in the years in question was at all times the property of its stockholder-patrons and/or their assigns, and taxpayer did claim a deduction in the amounts set forth in sixteen (16) above. The returns as filed disclosed no taxable income. (R-209).

19. Valley Cement Sales, Inc. is a corporation organized and legally existing under the laws of the State of Mississippi. It is a separate and distinct legal entity actively engaged in the conduct of business. A copy of its Charter is attached as Exhibit *E-2.*

20. On February 21, 1966, the corporation paid to the District Director of Internal Revenue Service, Jackson, Mississippi a total of $150,474.50 applicable to its fiscal year ended January 31, 1962. The aforegoing amount included $122,202.56 of alleged taxes due and owing and $28,271.94 of assessed interest.

21. On February 21, 1966, the corporation paid to the District Director of Internal Revenue, Jackson, Mississippi, a total of $158,019.08 applicable to its fiscal year ended January 31, 1963. The foregoing amount included $134,946.01 of alleged tax deficiencies, plus assessed interest of $23,073.07.

22. On February 21, 1966, the corporation paid to the District Director of Internal Revenue, Jackson, Mississippi a total of $197,068.39 applicable to its fiscal year ended January 31, 1964. The foregoing amount included $177,382.48 of alleged tax deficiencies plus assessed interest of $19,685.91.

23. Taxpayer did timely file claims for refund with the District Director of Internal Revenue, Jackson, Mississippi as follows:

Year Ended	Amount of Sought Refund
1-31-62	$150,474.50
1-31-63	158,019.08
1-31-64	197,068.39

24. Taxpayer's Claims for Refund were officially rejected by the District Director of Internal Revenue, Jackson, Mississippi on May 19, 1966. (R-210)

25. Any use herein of the terms "cooperative", "patrons" or "patronage" or "stockholder" or "dividend" is not intended to resolve, by the mere use of terminology, any issue with reference to the legal status of the persons or items.

26. Additional exhibits requested by Defendant and admitted by the plaintiff to be true copies are: A copy of the prospectuses issued and published by Mississippi Valley Portland Cement Company in 1957 and in 1958, Exhibits *E-3* and *E-4;* a copy of the minutes of the Executive Committee of the Board of Mississippi Valley Portland Cement Company of August 17, 1959, Exhibit *E-5.*

27. Relative to the "policy of the company" alluded to in the minutes of the Executive Committee, Exhibit *E-5,* the policy was to endeavor to use responsible licenced carriers for the transportation of cement and not to encourage individuals to pick up cement at the plant, because of the adverse effect on insurance rates and the disruption of the operation of the company's physical loading facilities and the consequent over-all increase in the cost of handling the product to the detriment of all patrons.

28. It was not the general practice among a majority of individual patrons to physically handle the cement allocated to them but to depend upon their assignee, Valley Cement Sales, as their agent in this respect.

29. All conditions precedent to the right of Plaintiff to file this suit and invoke the jurisdiction of this Court for a determination of the matters at issue have been complied with.

30. If Plaintiff-Taxpayer prevails on the issue of the excludability of distributions to stockholder-patrons, the (R-211) entire tax paid for the three fiscal years involved plus interest as may be allowed by law is due to be refunded. If the Defendant prevails on the stated issue, other issues will remain in the case for decision, and it is the intent and desire of the parties to first resolve said stated issue and have the Court retain jurisdiction for resolving other issues if and when necessary.

31. As to the stated issue, the case is submitted for decision by the Court on the pleadings and this stipulation. A jury is waived. Both parties reserve all objections to any stipulated fact as to the relevancy and materiality thereof.

32. In the event that this issue is decided for Plaintiff, the parties hereby agree that the amount of the judgment awarded to Plaintiff shall be computed by the Internal Revenue Service. In the event that the parties are unable to agree as to amount, the amount of the judgment shall be finally determined by this Court.

s/ Vardaman S. Dunn
Attorney for Plaintiff
s/ Robert E. Hauberg
and
s/ Hubert M. Doster
Attorneys for Defendant

APPENDIX B

Opinion

This action is for the recovery of income taxes, which plaintiff-taxpayer alleges were illegally assessed and collected, and is before the Court on the pleadings, a stipulation of facts, and briefs of opposing counsel.

The Court finds that the facts are as set forth in the Stipulation of Facts which are a part of the record herein. As the stipulation is lengthy and the exhibits attached thereto voluminous, only so much of them as are necessary to a decision will be referred to.

According to the stipulation the one issue to be determined at the present time is the excludability from taxable income of distributions awarded to stockholder-patrons of the corporate taxpayer during each of the taxable years ended January 31, 1962, January 31, 1963 and January 31, 1964. A resolution of this issue in favor of taxpayer would result in a refund to taxpayer of the tax and interest assessed, totaling $505,561.97 paid on February 21, 1966, together with interest from that date. Should the defendant prevail, other issues remain.

Plaintiff, also referred to herein as taxpayer or company, was incorporated in Mississippi in February 1956. Of 500,000 shares of stock, approximately 417,000 shares were issued to 8 individuals, and the balance to friends, relatives and employees. In March and April 1957 an additional 1,400,000 shares (R-283) were sold to the general public in four southern states, approximately 90% being sold in Mississippi. Registration Statements authorizing the sale of stock were filed with the Securities and Exchange Commission in Washington, D. C., and with appropriate state agencies. The company was organized as a cooperative for

the purpose of manufacturing and selling cement. Its charter provides that the record owner, or its assign, of every five shares of stock has a preferred patronage right to purchase one barrel of cement during each fiscal year. In January, prior to each fiscal year beginning February 1 of the tax years in question, the Board of Directors adopted a similar resolution allocating the entire cement production to the stockholder patrons or their assigns on the basis of their stock ownership. It was further resolved that any profit margins from the production of cement would belong to the stockholder-patrons of record at the end of each fiscal year to be held for their account in trust and refunded as a patronage rebate, in either cash or reserve certificates, with the further provision that the obligation of the company to produce cement as an agent and trustee of its stockholder-patrons would be enforceable as a contract. It was further provided that sales of cement would be made to or for the account of Valley Cement Sales, Inc., a separate corporation organized as a sales agency for the benefit of stockholders-patrons who assign to it their patronage rights, and any cement not taken by stockholders or their assignees each month following production could be sold by the Company or delivered to the sales agency for the account of such stockholders. In the tax years involved, all cement was delivered to the sales agency for sale in accordance with either assignments of patronage rights or as provided by the resolutions referred to above. At the conclusion of each tax year the net receipts from sales of cement, over and above (R-284) production costs, were allocated or distributed to stockholder-patrons of record at the end of each fiscal year on a pro-rata basis. As stated above, the resolutions of taxpayer's Board of Directors allocated the entire production of cement to its patronage-stockholders, and it is not shown that taxpayer had any stockholders other than patronage-stockholders, or did any business except on behalf of patronage-stockholders.

Taxpayer, in its income tax returns for the fiscal years involved excluded the aforesaid patronage rebates, reporting no taxable income. Taxpayer's contention is that, as a non-exempt, cooperative corporation, its distributions of patronage dividends are excludable.

Pertinent statutes include the general definition of gross income, 26 U.S.C.A., Sec. 61 (a) (2) and (3). and statutes, effective after December 31, 1962, which specifically exclude patronage dividends as defined therein, and which statutes are as follows:

"SECTION 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * * * *

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

* * * * *

(26 U.S.C. 1964 ed., Sec. 61.)

SECTION 1381. (as added by Sec. 17 (a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960)[1]

(R-285)

ORGANIZATIONS TO WHICH PART APPLIES.

(a) *In General.*—This part shall apply to—

(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

1. This section of the Code is effective for taxable years beginning after December 31, 1962.

(2) any corporation operating on a cooperative basis other than an organization

(A) which is exempt from tax under this chapter,

(B) which is subject to the provisions of—

(i) part II of subchapter H (relating to mutual savings banks, etc.), or

(ii) subchapter L (relating to insurance companies) or

(C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.

* * * * *

(26 U.S.C. 1964 ed., Sec. 1381.)

SECTION 1388. (as added by Sec. 17 (a), Revenue Act of 1962, *supra*)[2] DEFINITIONS; SPECIAL RULES.

(a) *Patronage Dividend.*—For purposes of this sub-chapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies—

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

2. This section of the Code is effective for taxable years beginning after December 31, 1962.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions."

As to patronage dividends allocated or distributed prior to the effective date of Section 1381 and 1388, taxpayer relies on prior tax rulings and court decisions, particularly the (R-286) holdings of *United States* v. *Mississippi Chemical Company,* (5th Cir.) 326 F.2d 569, affirming a District Court decision in *Mississippi Chemical Company* v. *U. S.,* 197 F. Supp. 490. In that case, it was held that the relationship between the non-exempt cooperative taxpayer and its stockholder-patrons met all the recognized tests required in order to exclude patronage dividends. The Court said:

"The basic principles of law governing the taxation of non-exempt cooperatives may be thus summarized:

(1) When a legally enforceable obligation exists to refund to qualified purchasers (stockholder-patrons) their proportionate share of gross receipts above costs and operating expense based upon their respective purchases, such receipts are income of the patron and not income of the cooperative and consequently are to be excluded in the computation of the cooperative's gross income.

This exclusion is enforced by the courts on the grounds that (1) under the pre-existing legal obligation the margins never become the property of the cooperative and are not a part of its income, (2) money received by one in a business transaction which he has no right to retain but must account for to another cannot be said to be a gain or profit to him, (3) patronage refunds are distributions of money belonging to the

> patrons rather than distribution of income of the cooperative, (4) while held by the cooperative the funds are in its hands as agent or trustee for its patrons to whom it is legally obligated to repay the same, and (5) patronage refunds are in reality discounts or rebates paid under a pre-existing legal obligation and are just as allowable as any other discount upon the purchase price of any commodity. Commissioner v. Wilcox, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752; Saenger v. Commissioner, 5th Cir., 69 F.2d 633; Uniform Printing & Supply Co. v. Commissioner, 7 Cir., 88 F.2d 75; Farmers Cooperative Co. v. Birmingham, N.D. Iowa, 86 F. Supp. 201; State of Mississippi v. Morgan Gin Co., 186 Miss. 66, 189 So. 817."

Since December 31, 1962, the above quoted statutes recognize the excludability by a true non-exempt cooperative of patronage dividends, provided the conditions stated therein are met.

The distinguishing features between the case at hand and *U. S.* v. *Mississippi Chemical Company,* supra, and the (R-287) cases cited therein in support of excludability seems to this Court to lie in the fact that the taxpayer in those cases was found to be a true cooperative, organized to do business with its patrons. As stated in Mississippi Chemical, page 573:

> "The record demonstrates, and the district court found, that the Mississippi Chemical Corporation and its patrons and its stockholders or members 'really meant to, and did, conduct business' in accordance with the provision of its charter."

Farmers Cooperative Co. v. *Birmingham,* 86 F. Supp. 201, recites the history of the rapid growth in this country of cooperatives in operating for the mutual benefit of either consumer or producer members, which groups normally have a common purpose of either consuming the product furnished by the cooperative or selling to the cooperative their common products. The Congress has benefited such

businesses which meet certain requirements with tax exemption. For those of non-exempt status, no statute until 1962 excluded patronage rebates, but rulings of the Tax Commissioner and the courts generally did.

There is nothing in the method of doing business by the taxpayer in this case that distinguishes it from the average or normal corporation doing business for profit, no matter that taxpayer is called a cooperative, or that the dividends to stockholders are referred to as patronage rebates. Other characteristics of this taxpayer akin to that of a corporation for profit is that the dividends were payable only to stockholders of record at the end of each fiscal year, leaving stockholders, who might have sold their shares prior thereto, with no entitlement to a rebate on the basis of earnings during the fiscal year; and the fact that, as stipulated, actually no stockholder used the cement produced. All allocations were assigned to a sales agency or sold by that agency. As further stipulated, any (R-288) allocations and delivery of cement to a patron were discouraged.

It is the opinion of this Court, after carefully scrutinizing the structure of this taxpayer and its method of doing business, that it was not doing business with its consumer patrons or assigns in the historical sense of a consumer cooperative, but that its stockholders are in no different category from that of any corporation interested in profits, no matter whether the source of that profit be from the production of cement or any other product, and that accordingly the sums paid here are not excludable from taxable income.

Let the government prepare an appropriate order to this effect, retaining the jurisdiction of this Court on such other issues as might be involved.

s/ Dan M. Russell, Jr.
United States District Judge

DATED: October 27, 1967.

APPENDIX C

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 25618

MISSISSIPPI VALLEY PORTLAND CEMENT COMPANY,

Appellant,

versus

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Southern District of Mississippi

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(March 14, 1969)

Before GOLDBERG and AINSWORTH, Circuit Judges, and SPEARS, District Judge.

GOLDBERG, Circuit Judge: The taxpayer, a non-tax-exempt cooperative incorporated in Mississippi, sought to deduct distributions to its shareholders from its corporate income tax as "patronage dividends."[1] These payments were made from the corporation's net profits during the tax years in question. The district court, agreeing with the Commissioner, said that notwithstanding the

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[1] See generally Clark and Warlich, *Taxation of Cooperatives: A Problem Solved,* 47 Minn. L. Rev. 997 (1963); Comment, *Taxation of Cooperatives Under 1962 Revenue Act,* 41 Tex. L. Rev. 908 (1963); *cf.* Logan, *Federal Income Taxation of Farmers' and Other Cooperatives,* 44 Tex. L. Rev. 250 (1965).

cooperative camouflage, these payments were in reality no more than dividends paid to the corporation's shareholders, and held that they were not deductible as patronage dividends.[2] We, like the district court, cannot sanction

2. Internal Revenue Code of 1954:

SEC. 1381. ORGANIZATIONS TO WHICH PART APPLIES.

(a) In General.—This part shall apply to—

(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(2) any corporation operating on a cooperative basis other than an organization—

(A) which is exempt from tax under this chapter,

(B) which is subject to the provisions of—

(i) part II of subchapter H (relating to mutual savings banks, etc.), or

(ii) subchapter L (relating to insurance companies), or

(C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.
(26 U.S.C.A. § 1381)

SEC. 1382. TAXABLE INCOME OF COOPERATIVES.

(a) *Gross Income.*—Except as provided in sub-section (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization.

(b) *Patronage Dividends.*—In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year; or

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred. For purposes of this title, any amount not taken into account under the preceding sentence shall be treated in the same manner as an item of gross income and as a deduction therefrom.

* * *

(26 U.S.C.A. § 1382).

a masquerade wherein a dividend is costumed in the habiliments of a patronage dividend. The judgment of the court below is affirmed.

I.

The relevant facts have been stipulated by the parties and may be summarized as follows:

The Mississippi Valley Portland Cement Company, the taxpayer, was incorporated in the State of Mississippi in 1956. Initially it issued 500,000 shares of stock, of which approximately 417,000 shares were issued to eight individuals, and the balance to their friends, relatives, and employees.[3] In 1957 it issued an additional 1,400,000 shares which it sold to the general public in four southern states, with approximately ninety percent being sold in Mississippi.

The taxpayer was organized as a cooperative under Mississippi law to manufacture and sell cement. Its charter, as amended, provided that the record owner of every five shares of stock had a preferred patronage right

3. The principal owners of the stock originally issued by the taxpayer were as follows:

Name	*Shares*	*Occupation*
R. W. Hyde	69,798	Pres., Construction Co.
Cecil F. Travis	46,993	Attorney
James W. Sanders	46,993	Pres., Textile Co.
A. N. Morgan*	83,911-1/3	Accountant
Kent B. Diehl	50,005	Consulting Engineer
David W. Adams	42,855	Public Relations Counsel
Calvin Huffman	66,230	Businessman; Promoter
James Fowler	10,000	Pres., Automobile Agency
Total	416,785-1/3	

*Held in various trusts for benefit of Mr. Morgan's minor children and wife.

to purchase one barrel of cement during each fiscal year.[4] The stockholders and their assigns would have to buy the cement at the prevailing market price; but, to the extent that the sales price exceeded the cost of production and sale, patronage refunds would be paid to the stockholders annually in proportion to the amount of cement allocated to them or to their assignees.

Pursuant to authority conferred upon it by the corporate charter, the taxpayer's board of directors adopted resolutions in January of each relevant year, prior to the February 1 beginning of the taxpayer's fiscal year, allocating the plant's entire production of cement to the stockholder-patrons or their assigns on the basis of their stock ownership. These board resolutions also provided that any profit margins from the production of cement should belong to the stockholder-patrons of record at the end of each fiscal year, and that they would be refunded as a patronage rebate, either in cash or reserve certificates. The taxpayer's obligation to produce cement and to allocate it to the shareholders was to be enforceable as a contract.

The resolutions additionally provided that sales of cement would be made to or for the account of Valley Cement Sales, Inc.[5] Valley Sales is a separate non-tax-exempt

4. In the period of its corporate existence during which stock was being sold, the taxpayer filed registration statements with the Securities and Exchange Commission and with corresponding agencies of the State of Mississippi and several surrounding states. The prospectus, as included in the registration statements, stated that every stockholder had a patronage right to purchase cement in proportion to the amount of stock held and that such patronage rights were assignable.

5. The resolution adopted at the board meeting on January 17, 1962, provides in part as follows:

> "7. Sales of cement will be made to or for the account of Valley Cement Sales, Inc., a Corporation organized as a sales agency for the benefit of stockholder-patrons who assign to it their patronage rights, at the market price to consumers less a quantity discount to be negotiated between the two Companies and the Company will rebate to Valley Cement

cooperative corporation organized by several of Mississippi Valley Portland Cement Company's officers, directors, and stockholders as a sales agency for the stockholder-patrons. The taxpayer subsequently entered into contracts with Valley Sales whereby it assigned to the latter all patronage rights to cement produced by the taxpayer during the forthcoming fiscal year and not purchased by the stockholder-patrons or others. During the relevant year, all of the cement produced by the taxpayer was delivered to Valley Sales to be sold to the general public.

At the conclusion of each tax year, the net receipts from sales of cement over and above production costs were allocated and distributed by the taxpayer to its stockholders of record in proportion to each person's stock ownership as of the year's end. It was not shown that the taxpayer had any stockholders other than those designated by it as stockholder-patrons, or that it did any business except on behalf of its stockholder patrons.

In its income tax returns for its fiscal years ending January 31, 1962, 1963 and 1964, the taxpayer excluded the following amounts from its gross income as patronage dividends either allocated or paid to its stockholder-patrons:

Year ended	*Margin allocated or paid to stockholder-patrons*
1-31-62	$ 285,215.14
1-31-63	454,208.41
1-31-64	421,296.68
	1,160,720.23

Sales, Inc. in accordance with the total patronage rights of its assignors as covered in said assignments.

"8. Any cement produced and not taken by stockholders or their assignee by the 30th day of the month following production may be sold on the open market by Mississippi Valley Portland Cement Company for the account of its stockholder-patrons, as their interests may appear, or the Company may deliver such unclaimed cement to Valley Cement Sales, Inc. on the terms aforesaid."

As a result of these exclusions, the taxpayer reported no taxable income for these years. The Commissioner, in reviewing the taxpayer's return, determined that the distributions to shareholders did not qualify as patronage payments, and therefore that the taxpayer owed a total tax of $505,561.97 for the three years in question.

The taxpayer paid the assessment and then sued in the district court for a refund of that amount. In holding that the Commissioner's assessment was correct and that the taxpayer was not entitled to a refund, the district court wrote as follows:

> "There is nothing in the method of doing business by the taxpayer in this case that distinguishes it from the average or normal corporation doing business for profit, no matter that the taxpayer is called a cooperative, or that the dividends to stockholders are referred to as patronage rebates. Other characteristics of this taxpayer akin to that of a corporation for profit is that the dividends were payable only to stockholders of record at the end of each fiscal year, leaving stockholders, who might have sold their shares prior thereto, with no entitlement to a rebate on the basis of earnings during the fiscal year; and the fact that, as stipulated, actually no stockholder used the cement produced. All allocations were assigned to a sales agency or sold by that agency. As further stipulated, any allocations and delivery of cement to a patron were discouraged.
>
> "It is the opinion of this Court, after carefully scrutinizing the structure of this taxpayer and its method of doing business, that it was not doing business with its consumer patrons or assigns in the historical sense of a consumer cooperative, but that its stockholders are in no different category from that of any corporation interested in profits, no matter whether the source of that profit be from the production of cement or any other product, and that accordingly the sums paid here are not excludable from taxable income."

II.

The sole question presented by this appeal is whether the district court erred in holding that the taxpayer's distribution of its net profits in the years in question could not be categorized as patronage dividends.[6] To answer this question we look first to the statutory definition of a "patronage dividend." Section 1388 (a), as added by the Revenue Act of 1962, provides:

"(a) *Patronage Dividend.*—For purposes of this subchapter, the term 'patronage dividend' means an

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6. We agree with the taxpayer's argument that a patronage dividend is an item which is "excluded" rather than "deducted" from the taxpayer's gross income. This distinction, while peripheral to the merits of this case, is not unimportant. A taxpayer has a far more difficult burden in trying to prove that he is entitled to a deduction, which is allowed as a matter of legislative grace, than he does in showing that a distribution is not income. See *Davis* v. *United States,* 2 Cir. 1937, 87 F.2d 323, *cert. denied,* 301 U.S. 704, 57 S.Ct. 937, 81 L.Ed. 1359.

We find that both the cases and a literal reading of the Code to support the taxpayer's contention that patronage payments are properly termed "exclusions." In *Farmers Cooperative Co.* v. *Birmingham,* N.D. Iowa, 1949, 86 F.Supp. 201, 217, we read:

> "Some confusion apparently exists as to whether a patronage dividend is properly termed a 'deduction' or an 'exclusion' from cooperative gross income. It is in fact considered by the Treasury Department as an exclusion from gross income. G.C.M. 17895, C.B. 1937-1, 56; I.T. 3208, C.B. 1938-2, 127. It is believed that the use of the term 'exclusion' instead of 'deduction' makes for clarity. See Bradley, Taxation of Cooperatives, Harvard Business Review 576, 577 (Autumn, 1947)."

See also *United States* v. *Mississippi Chemical Co.,* 5 Cir. 1964, 326 F.2d 569, 574-5; *cf. Pomeroy Cooperative Grain Co.* v. *Commissioner,* 8 Cir. 1961, 288 F.2d 326.

Section 1381 of the Code, enacted in 1962, generally incorporates prior case law regarding patronage payments and in particular incorporates the judicial labeling of such distributions as exclusions. Section 1381 in relevant part provides that "the gross income of any organization to which this part applies shall be determined without any adjustment . . . by reason of any allocation or distribution to a patron out of the net earnings of such organization." The intent to treat these payments as exclusions could not be clearer if Congress had used the word "exclusion." We therefore approach the question *sub judice* in full recognition of the burden of proof arising out of the exclusionary nature of patronage dividends.

amount paid to a patron by an organization to which part I of this subchapter applies—

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) *such amount is out of earnings other than from business done with or for patrons,* or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions." [Emphasis added.] [26 U.S.C.A. § 1388].

Of particular importance to the disposition of this case is the language requiring that the distribution be made out of earnings from "business done with or for patrons." The Commissioner would have us construe the words "with or for" to mean that the patrons must physically handle the

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7. Sections 1381 et seq. did not become operative until December 31, 1962. Thus, technically speaking, § 1388 is applicable only to the last of the three tax years involved in this appeal. With respect to the definition of a patronage distribution, however, sections 1381 et seq. are merely a codification of prior case law. See 1962 *U.S. Code Cong. and Adm. News* 3414 ff; *cf. Pomeroy Cooperative Grain Company* v. *Commissioner,* 8 Cir. 1961, 288 F.2d 326 (discussion of prerequisites to excludability of patronage payments); *Farmers Cooperative Co.* v. *Birmingham,* N.D. Iowa 1949, 86 F.Supp. 201 (discussion of prerequisites to excludability of patronage payments and history thereof). Our construction of § 1381 will, therefore, be made in the light of the preexisting case law; and our result, although discussed in statutory terms, should be considered as based on pre-section 1388 case law insofar as the first two tax years are concerned. In short, the statutory and the preexisting judicial expositions of the necessary elements of a patronage dividend are identical, and the result in this case would be the same under either.

products of the cooperative. The taxpayer, on the other hand, argues that neither the statute nor the cases have imposed such a physical contact requirement. We note that in most bona fide cooperative arrangements the patron does in some manner actually touch the subject matter of the transactions. For example, a marketing cooperative usually sells to the general public commodities or products of the patron, and a purchasing cooperative usually purchases items to be used or consumed by the patron. *cf. American Box Shook Export Ass'n* v. *Commissioner,* 9 Cir. 1946, 156 F.2d 629; *Farmers Cooperative Co.* v. *Birmingham,* N.D. Iowa 1949, 86 F. Supp. 201, 210-217. Extending the syllogism, a manufacturing cooperative should usually, but not always, consume or otherwise physically use the product of the cooperative. *cf. Fruit Growers' Supply Co.* v. *Commissioner,* 9 Cir. 1932, 56 F.2d 90. Thus, evidence that the patron actually used the product points logically to the conclusion that the business was conducted "with or for" such patron. Conversely, the absence of such evidence would support, but not compel, a conclusion to the contrary.

Since the absence of patron contact with the cement is not decisive, we must delve more deeply into the record. All of the cement produced by the taxpayer was allocated to the shareholder-patrons at the beginning of each fiscal year by a resolution of the board of directors. These resolutions gave the shareholder-patrons the option of either physically taking the cement or, by inaction, allowing their share to be assigned to a sales agency which would sell the cement to the general public in their behalf. In practice, instances of shareholder-patrons actually taking cement from the plant were almost non-existent and virtually all of the cement was assigned to the sales agency. Counsel for the taxpayer explained this circumstance by

saying that the patrons had to be discouraged from picking up cement at the plant because their small orders were too disruptive of plant operations.

Thus, generally speaking, the stockholder-patrons never had any actual use for or contact with the product of their corporation. The closest they came to the cement was to receive a right to X-number of barrels of cement which was semi-automatically assigned to a sales agency.[8] Pointing to this circumstance, the Commissioner contends that the stockholder-patrons used the cement only for the purpose of gaining a return on their investment in the corporation and that such returned earnings are in economic substance no different from the dividends paid by a typical corporation to its shareholders. He argues that the allocations and assignments of cement were merely paper transactions devoid of economic substance and that their only function was to enable the taxpayer to pass its net profits on to its shareholders without such profits ever be-

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8. In the record we find the following stipulations:

"11. Approximately 90% of the stock of Mississippi Valley Portland Cement Company was represented by executed assignments to Valley Cement Sales in 1960, when the company began production of cement. All stockholders received the same pro-rata distributions whether assignments were executed or not, at times pertinent to this suit.

"12. In the years ended January 31, 1962-1964, inclusive, the entire amount of production had by Mississippi Valley Portland Cement Company was, in accordance with properly executed assignments on the part of its stockholder-patrons, or in accordance with the provisions of the Charter and resolutions of its Board of Directors as aforesaid, delivered by Mississippi Valley Portland Cement Company to Valley Cement Sales, Inc."

ing included in the corporation's gross income under § 61 of the Code.[9]

The thrust of the Commissioner's argument is that this Court should characterize these transactions as sham transactions, and should hold that the taxpayer's profits were really earned from sales of cement to the general public. The result of such a holding would be that the corporation's profits would not be from business done "with or for" its patrons, and therefore that such dividends would not be excludable from its corporate income as patronage dividends.[10] See Rev. Rul. 57-59.

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9. § 61. Gross income defined [26 U.S.C.A. § 61]

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

10. In the legislative history of the Revenue Act of 1962 we find the following commentary on the meaning of "business done with or for patrons":

"It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical trans-

We have lifted the cooperative veil and have unmasked the economic realities of these transactions.[11] Our conclusion is that the taxpayer's shareholders were no more than paper patrons, and "that the distribution to stockholders was nothing more than a dividend paid out of profits of the corporation." *Peoples Gin Co., Inc.* v. *Commissioner*, 5 Cir. 1941, 118 F.2d 72, 73. The corporate conspectus and prospectus show that the taxpayer's business was selling cement to the general public. Its shareholders were merely investors and non-essential links in a conduit to

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actions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend." 1962-3 Cum. Bull. 707-721; 1962-2 U.S. Code and Adm. News 3620.

11. It is well established that "our income tax law is premised on fact and not fiction." *Blackstone Realty Co.* v. *Commissioner*, 5 Cir. 1968, 398 F.2d 991, 996. While a taxpayer is free to arrange his business with an intent to avoid or minimize taxes, his transactions are to be analyzed for their pragmatic realities. Id. As we stated in *Redwing Carriers, Inc.* v. *Tomlinson*, 5 Cir. 1968, 399 F.2d 652, 657, "both the Supreme Court and our Court have on numerous occasions stated that when the realities of a transaction differ from its paper shell, the Internal Revenue Service and the courts may open the shell and look inside to determine the substance of the transaction." In *Higgins* v. *Smith*, 1940, 308 U.S. 473, 60 S.Ct. 355, 84 L.Ed. 406, 411, the Supreme Court wrote:

> "A taxpayer is free to adopt such organization for his affairs as he may choose and, having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> "On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property."

Thus in the case at bar we must examine the record to determine the economic substance of the allocations of cement to the stockholder-patrons. While the taxpayer's transactional documentations including registration statements is relevant, it is not a controlling indicant of economic reality.

the outside, not consumers of the corporate product. The distributions to these shareholders, therefore, represented profits from corporate dealings with the general public and should be taxed accordingly. See *Smith & Wiggins Gin, Inc.* v. *Commissioner*, 5 Cir. 1965, 341 F.2d 341, 347-51.

Although our finding that the taxpayer's shareholders were pseudo-patrons is based upon an examination of the record as a whole, we find two factors in this case to be particularly elucidative of the true nature of the distributions. First, the resolutions adopted by the taxpayer's board of directors, which is quoted in part in footnote 5, *supra*, shows the corporate intent and potential for open market operations. By providing for prepackaged semi-automatic assignments of the taxpayer's entire production, these corporate documents showed that the corporate purpose was not to supply its shareholders with cement at a reduced cost but to supply them with a return on their invested capital. Although they contained words which allocated the cement in kind, the resolutions had the practical effect of both channeling the cement to its ultimate consumers and declaring a dividend on the basis of such sales. These allocations were phantoms, and the shareholders were pseudo-purchasers. Thus, the true measure of the so-called patronage dividend was not how much cement the paper patron consumed, but rather how much the taxpayer earned by selling to others.

The second revealing circumstance is the absence of horizontal similitude among the stockholder-patrons. In the usual manufacturing cooperative situation, the patrons have a fraternal commercial relationship with respect to the business of the cooperative and its products other than as investors. For example, in *Fruit Growers' Supply Co.* v. *Commissioner*, *supra*, the cooperative "manufactured lumber and shook for the manufacture of packing boxes for

the marketing of fruit" for its patrons. 56 F.2d at 91. The patrons were fruit growers who had formed the cooperative to facilitate the procurement of fruit packing boxes at a minimum cost, and they clearly had a fraternal commercial relationship. In the case of a cement manufacturing cooperative it would be logical to expect that its patrons would be contractors, builders, and others with related occupations. Here, however, the businesses and professions of the principal shareholders are diverse: accounting, law, automobiles, construction, engineering, public relations, and textiles. It would be a travesty to regard this variegated and disparate conglomerate of shareholders as being cement oriented and connected. The only thing these shareholders had in common was an investment in what they hoped would be a money making venture, and in this respect their relationship to each other and to the corporation was no different from that of shareholders in any other publicly held corporation.

Notwithstanding the preceding, the taxpayer argues that this Court's opinion in *United States* v. *Mississippi Chemical Co.*, 5 Cir. 1964, 326 F.2d 569, compels a holding that its distributions to its shareholders were "patronage dividends". We have carefully studied both the opinion of our Court and that of the lower court in that case, 197 F.Supp. 490, and we have found nothing in either opinion which deals with what constitutes a bona fide patronage dividend, the issue at bar. In fact the Court's opinion begins with the assumption that the distributions to shareholders were bona fide patronage dividends. The only issue raised in *Mississippi Chemical* was the manner in which patronage dividends were to be computed. That issue was summarized by Judge Hutcheson as follows:

> "The basic contention of the appellant [the Commissioner], which was decided against it in the district court, is that the sole method of computation of

> the patronage dividends claimed in this case is that prescribed in the formulas laid down in Bureau rulings, decisions, and memorandums, and that no other method may be used."

Thus, we conclude that *Mississippi Chemical* is not controlling here.

The taxpayer attempted to clothe its shareholders as patrons and its corporate dividends as patronage payments. Like the district court, we find that the patronage vestments do not fit and therefore the taxpayer's distributions of net profits to its shareholders did not result from "business done with or for patrons." The generation of business is usually the result of positive action, but here the transactions attributed to the paper patrons resulted from inaction. The taxpayer's shareholders never had any actual contact with their allocations of cement; they arranged the corporate apparatus to sell cement to the general public; and they had no commercial fraternal relationship other than as investors. In economic substance the taxpayer's distributions were the same as ordinary corporate dividends, and consequently they could not be excluded from the taxpayer's gross income.

The judgment of the district court is

AFFIRMED.

APPENDIX D

United States Court of Appeals

FOR THE FIFTH CIRCUIT

OCTOBER TERM, 1968

No. 25618

D. C. Docket No. CA 3970

MISSISSIPPI VALLEY PORTLAND CEMENT COMPANY,

Appellant,

versus

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Southern District of Mississippi.

Before GOLDBERG and AINSWORTH, Circuit Judges, and SPEARS, District Judge.

Judgment

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Mississippi, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

Costs of the appeal shall be taxed against the appellant.

March 14, 1969

Issued as Mandate: